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SUBJECT: GVN HAS TOUGH ECONOMIC CHOICES AHEAD

Ref: A) Hanoi 634

B) Hanoi 774

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¶1. (SBU) Summary: Treasury Deputy Assistant Secretary Robert Dohner, in meetings with Vietnamese government officials on July 2 and 3, conveyed that Vietnam's prospects are still strongly positive but appropriate policy choices over the next few months would be critical to achieving a more stable macroeconomic situation.

Officials consistently responded that inflation is the government's highest priority, and agreed with DAS Dohner on the need for fiscal tightening (to cool Vietnam's overheating economy) and for improved communications with markets.

¶2. (SBU) There was less agreement (and in some cases lack of consensus within the government) on the extent of risks to the banking system; the need to increase interest rates to retain deposits in the banking system; the advisability of administrative measures targeted at reducing imports; and the need to ensure continuous trading and market clearing in the market for U.S. dollars.

¶3. (SBU) Finally, there appears to be some reconsideration (but no consensus) within the Vietnamese government of the advisability of granting banking licenses to state-owned industrial companies. End summary.

Larger Problems May Surface in Banking System

¶4. (SBU) DAS Dohner discussed banking system risks in separate meetings on July 2 and 3 in Hanoi with the State Bank of Vietnam (SBV) Deputy Governor for Bank Supervision, Nguyen Van Binh, and the Office of the Government's (OOG) Banking and Finance Department Director, Pham Van Phuong. Both OOG and SBV said that the banking system is "under control" and that the banking system has "survived the most difficult period." Binh reported that liquidity problems are confined to small joint stock commercial banks (JSCBs), which comprise only 5-6 percent of banking system assets, and that "state owned commercial banks and the larger JSCBs (comprising more than 90 percent of banking assets) are all safe and sound." [Comment: The SBV is providing "liquidity support" to a number of small private banks, about 12 -20 in total, and is holding them under close supervision.] Binh highlighted that the latest data from January showed non-performing loans (NPLs) in "the safe range" of 3.5 percent of total loans, a slight increase from 2 percent at the end of last year. A contact at the World Bank predicts, however, that NPLs will take another big jump before the end of the year. [Comment: NPLs are a backward looking measure. It usually takes 6

months to 1 year from the onset of a crisis for the NPL ratio to show a significant increase.]

¶15. (SBU) Dohner expressed concern about potential future problems in the banking sector, noting Vietnam's rapid credit growth amidst weak risk management and aggressive lending to the stock and real estate asset bubbles. [Comment: According to GVN calculations, in 2007 credit outstanding grew by 50 percent overall, and by over 90 percent for private sector banks. In the first quarter of 2008, overall credit grew approximately 15 percent compared to end of 2007.] Dohner urged officials to "get ready" and develop a response plan for bank failures that includes swift resolution of insolvent banks and protection for depositors.

¶16. (SBU) OOG's Phuong stated development of such a plan is underway, which was later confirmed by the World Bank representative. Phuong noted that small banks are receiving liquidity support because the GVN fears that any bank failure, no matter how minor, could cause a loss of confidence in the entire banking system. He explained that the "government has directed the SBV to support liquidity in the interbank market." He cited specific efforts to loosen criteria for participation in the interbank market including lowering the minimum value for negotiated paper and raising SBV's limits on short-term borrowing.

Direction of Interest Rates Being Debated

¶17. (SBU) In separate meetings with SBV's Binh, OOG officials, and Ministry of Planning and Investment (MPI) Deputy Director-General of National Economic Issues, Dr. Nguyen Phu Ha, DAS Dohner emphasized the importance of ensuring that bank deposits offer positive real rates of return to avoid withdrawals from banks to invest in gold or other durable goods. [Comment: Banks are experiencing difficult liquidity problems as depositors have been withdrawing funds from

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the banking system over the past several months. Interest rates have not been allowed to rise in line with inflation, thus offering depositors only negative real rates of return. Vietnamese have been placing their funds in alternative assets, notably gold. Gold imports increased 140 percent in first quarter 2008 compared to first quarter 2007 (Reftel A and B).]

¶18. MPI's Ha noted that debate on interest rates is ongoing within the GVN - manufacturers and exporters are pressing for lower interest rates, depositors for higher interest rates, and the government is seeking to "harmonize all, fight inflation, and have high growth."

¶19. (SBU) At a lunch with local representatives of foreign banks, one observed that JSCBs are lobbying against further increases in short-term interest rates and hinted that JSCBs are a powerful lobbying group as many of their CEOs are former SOCB officials. A representative from GE Money, which just won a license to start a consumer finance business in Vietnam, expressed concern that the Vietnamese would institutionalize caps on lending rates which would "head off consumer lending before it even gets started."

ForEx Market for U.S. Dollars Still Dysfunctional

¶110. (SBU) To SBV's Binh and OOG officials, Dohner emphasized the importance of having active trading in foreign exchange markets and expressed concerns about rationing of foreign exchange to reduce imports deemed non-critical. [Comment: In the week prior to DAS Dohner's visit, the SBV issued regulations forbidding two-way trading of dong and U.S. dollars through third currencies. This effectively froze the trading of U.S. dollars in the official market, and the SBV directed sales of its foreign exchange towards governmental priorities, e.g., oil imports and state-owned enterprises (SOEs). Reftel B]

¶111. (SBU) OOG's Phuong explained that reducing imports -- to reduce the trade deficit -- was one of three targets that had been outlined at a recent government meeting on addressing inflation. [Comment:

The other two targets are monetary and fiscal tightening.] Dohner argued that the government would achieve its goal of reducing imports by slowing economic growth and taking appropriate policy measures that convince the public that the dong would not rapidly lose value.

¶12. (SBU) Separately, a local banker observed to DAS Dohner at a bankers' lunch that "Vietnamese want gold, oil, anything except dong. They are afraid of devaluation and so are moving money out of the dong."

GVN Struggles to Tighten Fiscal Spending

¶13. (SBU) DAS Dohner noted that monetary policy cannot take the full brunt of reducing inflation, and urged that fiscal tightening must also be employed. He emphasized that in order to boost investor and public confidence the GVN needs to "demonstrate it can control expenditures." Officials were in strong agreement. Ministry of Finance (MOF) Vice Minister Ha discussed in detail their plan for fulfilling the Prime Minister's directive on cutting non-salary operational budget spending by 10 percent (which MOF expects will reduce spending by 20 trillion dong or approximately 1.8 percent of GDP.)

¶14. (SBU) On investment spending, MPI's Ha explained that in early April the Prime Minister issued a directive for non-critical investment projects to be delayed. However, when asked, ministries offered only small projects of little total value as non-critical. Instead, now the government plans to maintain the original planned amount of overall investment spending, but fund a fewer number of projects, as projects costs have increased with inflation.

¶15. (SBU) Discussions with MPI's Ha revealed a lack of clear state control over investment spending. She explained that investment decisions are decentralized to ministries, provinces and SOEs. Also she explained that despite cutbacks in government funds for investment projects (many of which involve SOEs), SOEs can and have been borrowing from banks to continue investments.

¶16. (SBU) On utilizing increases in the tax revenues, MPI explained that the government will not use additional tax revenue for increased expenditure, but instead for covering the deficit. MOF Vice Minister Ha explained that by law additional budget revenues

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are required to be placed in a reserve or to be used for social welfare projects.

Warnings Against Mixing Commerce and Finance

¶17. (SBU) In meetings with MPI's Ha and OOG officials, DAS Dohner expressed concern about SOEs' expansion into the financial sector. [Comment: In a May report, Fitch Ratings reported that authorities had issued nine additional banking licenses, almost all of which were given to state-owned corporate enterprises. According to a private banker, state-owned Vinashin, however, was recently forced to step back from an acquisition of a finance company.] Dohner explained that the United States was averse to non-financial companies owning banks, and felt that having banks owned by industrial companies had worked out badly for the Philippines and Indonesia.

¶18. (SBU) OOG's Phuong responded that the government "is studying the issue" and emphasized that Vietnam needs to develop its own solution appropriate for its economic needs. He stated that former Federal Reserve Governor Alan Greenspan had provided similar advice against mixing industrial and financial conglomerates during his meeting with Prime Minister Dung during the PM's trip to Washington in June.

GVN Aware of Need for Improved Communication

¶19. (U) Dohner encouraged officials to publish information

regularly on a publicly available schedule, noting that the demand and importance of information is now higher to calm markets. He encouraged them to disclose even disappointing information, as it would assure market participants that nothing is being hidden and would help prevent rumors.

¶20. (SBU) Officials were in strong agreement. MPI's Ha noted that Prime Minister Dung had recently instructed all agencies to better disclose information to the public. MOF's Ha noted improved information disclosure is necessary as "some investors don't understand Vietnam's economy."

¶21. (SBU) In terms of specific areas where more transparency and communication could be helpful, the IMF recently noted that the Ministry of Finance should make a revised budget publicly available so as to clearly indicate how the Prime Minister's order of a 10 percent fiscal spending cut will be implemented. Further, UNDP's Chief Vietnam Economist Jonathan Pincus has urged publication of SOEs audited accounts, to make transparent their level of spending and borrowing.

¶22. (SBU) Comment: Government officials, while for months having voiced anti-inflation rhetoric, appear to have finally shifted into greater action, likely instigated by the financial downturn of end-May. Further monetary and fiscal tightening is likely necessary, but risks lay with interest groups, such as manufacturers, exporters, and SOEs seeking to keep interest rates low and investment spending expansive. These entities are using the slowdown in 2008's second quarter growth to argue for loosening of policies.

¶23. (SBU) Two risks seem to be under-appreciated by officials. First, it appears that cutting investment spending will be extremely difficult given the decentralized nature of investment decision making. This year will test whether "the government is in charge of SOEs, or the other way around," one observer noted. Second, while government officials may be putting on a positive face to bolster confidence, they may be overly complacent about risks in the banking system. End Comment.

¶24. (U) Treasury cleared this cable.

MICHALAK